Financial sector's roles in the transition to carbon neutrality

Concluding remarks by Himino Ryozo, commissioner, Financial Services Agency of Japan, at the virtual research workshop *Climate-Related Financial Risks: Interactions of Climate Change and the Financial System*, hosted by the Financial System and Bank Examination Department of the Bank of Japan on March 25-26, 2021

Yesterday and today, we had a rich discussion on the interactions between climate related risks, the banking sector and asset prices, as well as their policy implications. Let me add comments from the perspective of a regulator who is in charge of both prudential and capital market regulations.

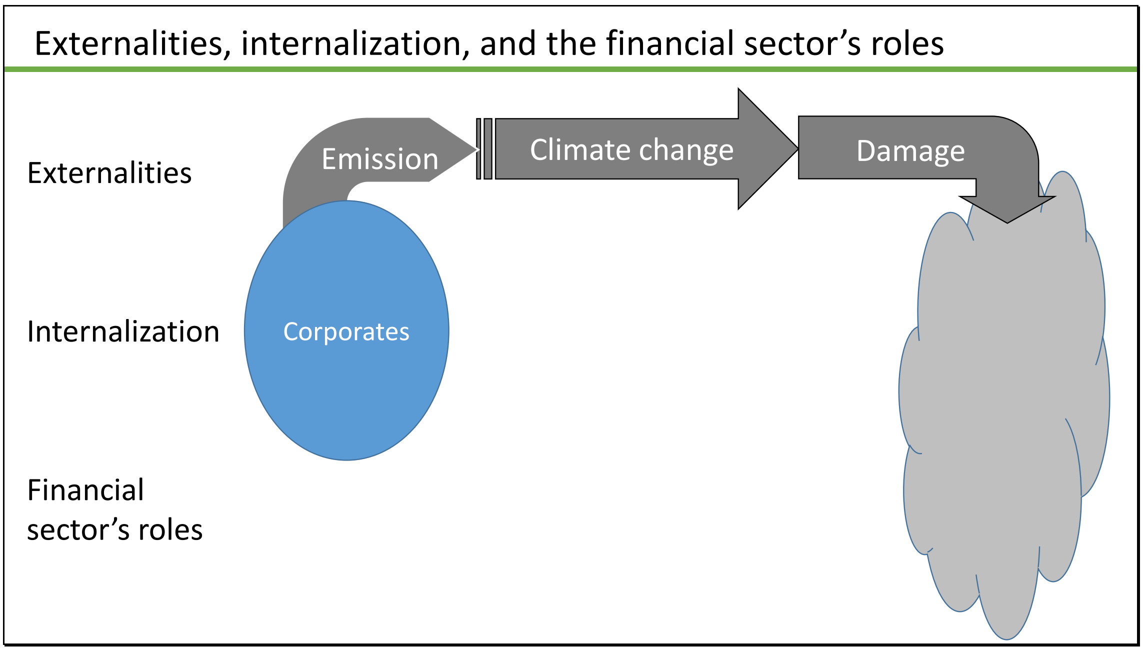
On one hand, emission entails negative externalities and climate related risks cannot be fully addressed by the market alone.

On the other, the financial sector has played its role mainly through the market. It prices risks and allocates resources in accordance with the price mechanism.

Here arise several questions. What roles should the financial sector play in the transition to net zero? Should it contribute to the goal mainly by ensuring that the market functions efficiently and effectively, or should it go beyond that? What should be the division of labor between the financial sector and other actors? What should the financial sector policies aim at?

Let me show you two slides.

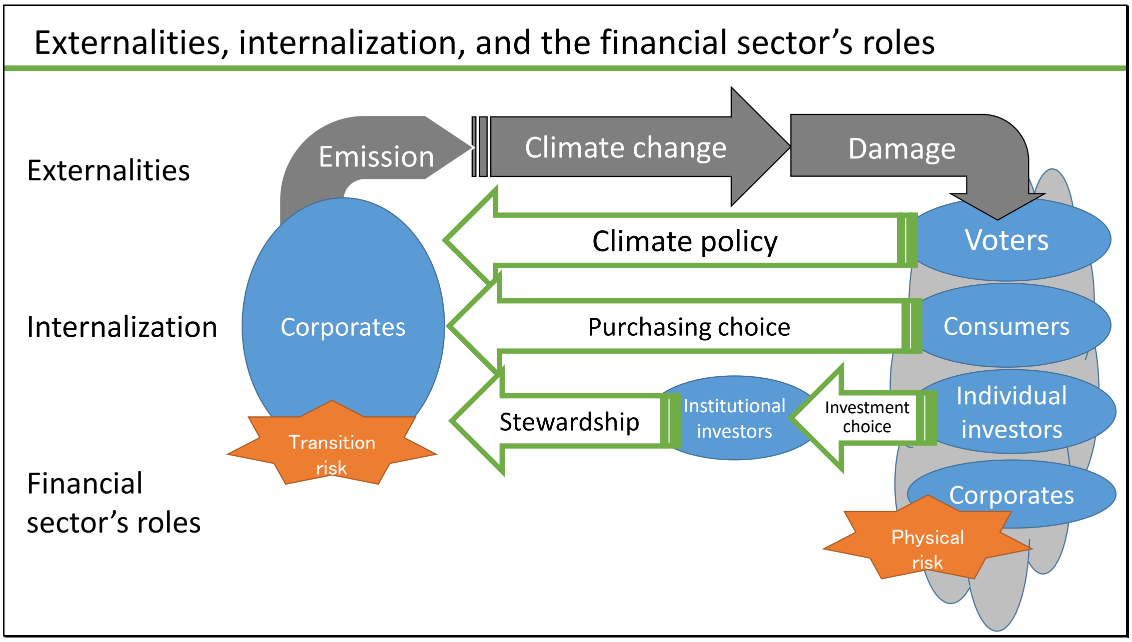
Externalities



The corporate sector makes emissions, which can cause climate change and damages on life. Significant part of the benefits of emission accrue to emitters, but the damages are shared by all. Hence emission entails a negative externality and can lead to the tragedy of the commons.

In addition, the damages can happen beyond the market participants' typical time horizons. Hence a negative intertemporal externality and the possibility of the tragedy of the horizon.

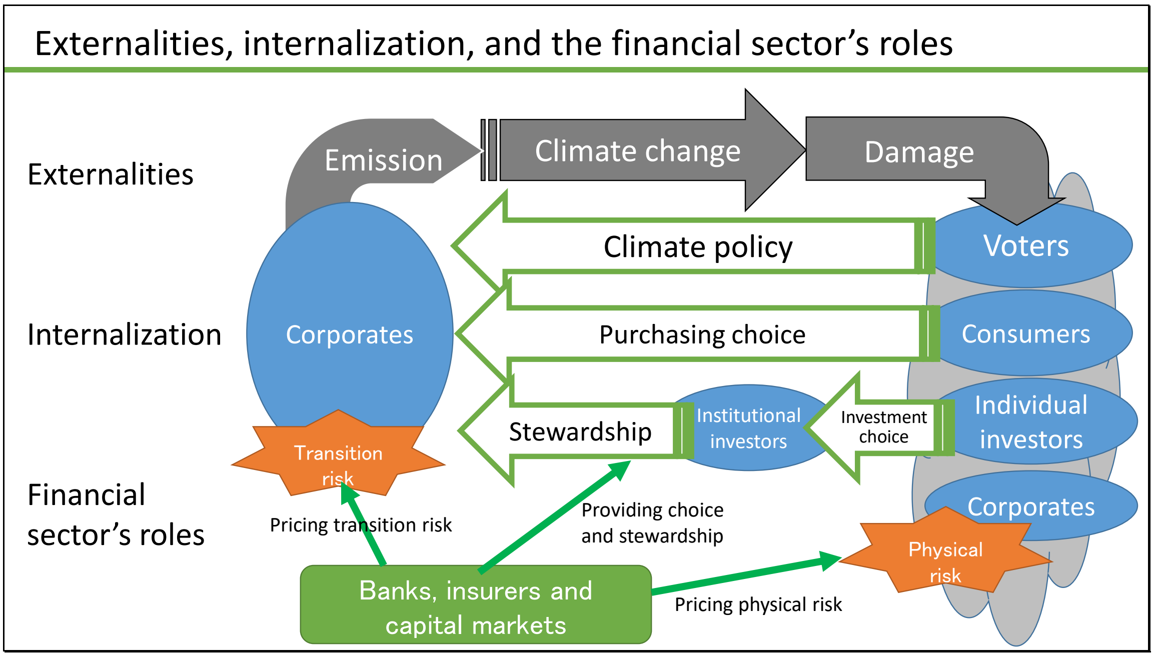
Internalization



But stakeholders who have incentives and means can act to make emitters internalize the externalities. For example, voters can demand the government to implement climate policy. Consumers can incorporate climate impacts in their purchasing choices. Individual investors can act through their investment choices. Institutional investors, in line with their fiduciary duty, exercise stewardship and reflect asset owners' views in their engagement with the invested companies and in their portfolio allocation.

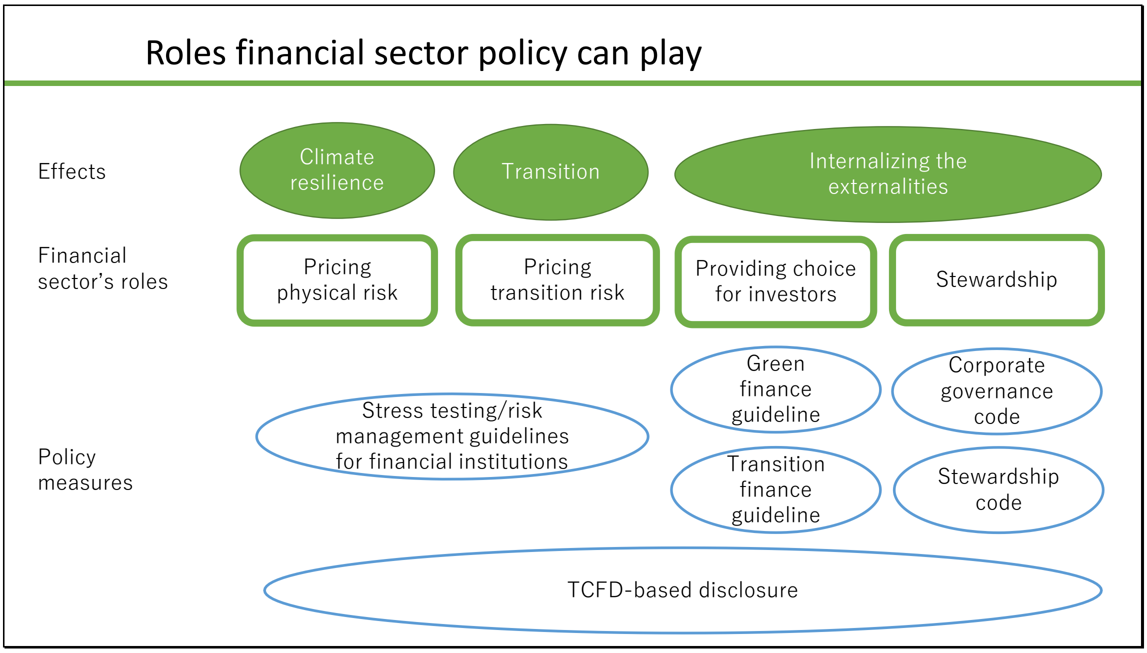
Changes in climate regulations and in consumer and investor behavior may create new opportunities for the corporate sector but may also make some business models unviable, exposing the corporate sector to transition risks. In addition, the corporate sector itself suffers from the physical damages as well and thus faces physical risks.

Roles of the financial sector



The financial sector can help the internalization by providing choices and stewardship to investors. It can also price transition risks and physical risks properly and help the economy adjust to reflect the externalities internalized, or to be internalized, by the acts of relevant stakeholders.

Roles of the financial sector policy



Both prudential regulators and capital market regulators can facilitate the financial sector playing these roles.

For example, regulators can work to ensure that financial institutions manage climate related financial risks properly. Such would contribute not just to financial stability but to better pricing of physical risks and thereby incentivize borrowers, issuers and insurance policy holders to build resilience against climate caused damages. In addition, proper pricing of transition risks will encourage them to invest for transition in a timely manner. Regulators can help alleviate the risk of the tragedy of the horizon by providing scenarios with longer time horizons for stress testing or scenario analysis.

The Financial Stability Board (FSB)'s Standing Committee on Supervisory and Regulatory Cooperation, which I chair, has established a Working Group on Climate Risk. The group is reviewing regulatory and supervisory approaches to addressing climate risks at financial institutions. In Japan, the Financial Services Agency (JFSA) is working with major financial institutions and the Bank of Japan on possible approaches to climate-related scenario analysis.

By setting guidelines for green finance and transition finance, regulators can also help the market provide reliable and transparent investment choices. Building on ICMA guidelines, the Japanese Ministry of Environment established the Green Bond Guidelines in 2017. The JFSA, the Ministry of Economy, Trade and Industry and the Ministry of Environment are currently working to formulate transition finance guidelines.

Regulators can also encourage institutional investors to exercise stewardship by setting a stewardship code. They can also encourage the corporate sector to engage with investors and other stakeholders by setting a corporate governance code. The Japanese codes already incorporate elements of sustainability, and the JFSA and the Tokyo Stock Exchange are currently working to introduce more specific principles at the forthcoming revision of the corporate governance code.

These will give investors voices and means to act to make issuers internalize the externalities.

A key foundation of all these activities is consistent and comparable disclosures. By encouraging the corporate and financial sectors to make climate disclosures, regulators can contribute to better internalization and better pricing of climate related risks. The G20 tasked the FSB to find ways to promote consistent, high-quality climate disclosures in line with the recommendations of the Task Force for Climate-related Financial Disclosures. The JFSA's chief sustainable finance officer, Ikeda Satoshi, co-leads the Workstream on Climate Disclosures that supports this work at the FSB. In Japan, one of the key elements of the forthcoming revision of the corporate governance code will be enhanced disclosure on sustainability.

The JFSA established an Expert Panel on Sustainable Finance last December and is looking forward to receiving recommendations.

Conclusion

I raised several questions at the beginning. As a step to answer them, I tried to explore how far we can go within the remit of the traditional roles of the financial sector and the financial sector policies. In developing policies, we may want to think further and clarify the roles of each player.

Before concluding my remarks, I would like to thank those who spoke yesterday and today for giving valuable insights which help us think about these and other questions. I particularly appreciate that, as the Bank of Japan organized this as a virtual workshop, a lot of foods for thoughts have been provided without too much green gas emissions.

Thank you.